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Supreme Court of the United States

OCTOBER TERM, 1944.

No. 932.

Trust u/w of MARY LILY (FLAGLER) BINGHAM, Messrs. WILLIAM R. KENAN, JR., and LAWRENCE C. HAINES, Trustees,

Petitioners,

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF FOR PETITIONERS.

ARTHUR A. BALLANTINE,
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Counsel for Petitioners.

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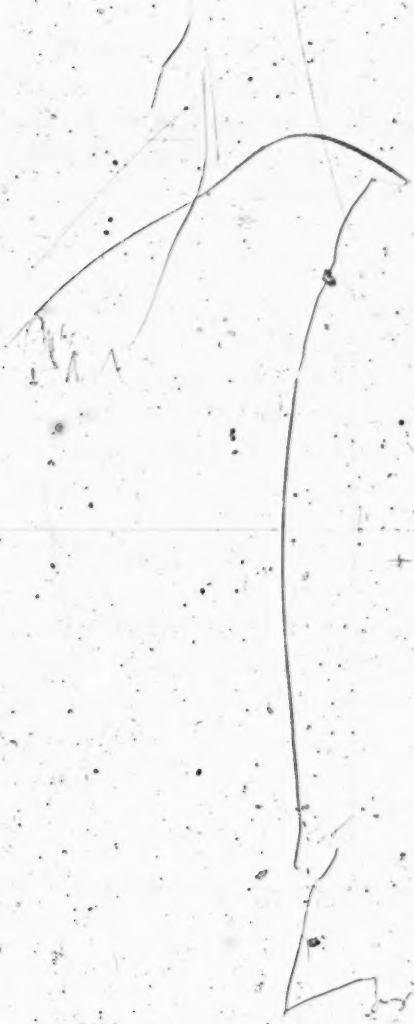

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Respondent.

REPLY BRIEF FOR PETITIONERS.

On analysis, the brief for the Respondent, the Commissioner of Internal Revenue, does not meet the proposition in Petitioner's main brief and in the petition for the writ that brought the case before this Court—that the Court below in reversing the decision of the Tax Court failed to apply the principle of *Dobson* v. *Commissioner*, 320 U. S. 489 (1943), to which that Court made no reference and failed to show that the Tax Court had proceeded on the basis of some clear-cut mistake of law. Specifically, we submit the following:

I.

Respondent fails to show that the question presented here is one of law.

What the Tax Court decided was that the expenditures by the Trustees (the Petitioners) here in question were expenses incurred for the management of property held for the production of income, and were hence deductible from income under the provisions of Section 23(a)(2) of the Internal Revenue Code as amended by Section 121 of the Revenue Act of 1942. The Court below reversed this decision, not on the ground which Respondent now chiefly suggests that it conflicted with Regulations of the Commissioner, but on the ground that the expenditures in question did not relate to the management of the trust property. This question, on which the decision turns, we maintain is essentially a question of fact and that under the principle of the *Dobson* case the decision in the Tax Court was final.

Respondent in his brief does not controvert any proposition of law advanced by the Tax Court. He does not, of course, deny that the Tax Court properly proceeded on the basis that ordinary and necessary expenses incurred for the management of property held for the production of income are deductible, as the statute plainly provides. Instead Respondent urges that this Court should promulgate two propositions, stated to be of law.

The first of these is

> "(1) That legal fees and charges incurred in distributing the corpus of a testamentary trust estate to the legatees are not expenses incurred 'for the management, conservation, or maintenance of property held for the production of income' within the

meaning of Section 23(a)(2) of the Internal Revenue Code as amended." (R. br., p. 12)

Clearly, such a proposition, if a proposition of law at all, is inapplicable here. The distributees were not legatees. The legatees under the will were the Trustees, the Petitioners. The beneficiaries took under the trust, not directly under the will.

But the proposition, even were it stated in reference to the particular facts before the Court, is hardly one of law. The question involved is one as to the application of a general statute to a particular state of facts—a matter which, under the *Dobson* decision, is left to the Tax Court for final determination.

The defect in the first suggested proposition of law is still more evident in the second proposition which is

> "(2) that expenses incurred after and just prior to the scheduled expiration of the term of a trust, in litigating an alleged tax deficiency of the trust, growing out of a payment previously made to a legatee, are not such expenses; or, more broadly, that the expense of opposing any tax deficiency affecting neither the yield nor the appreciation of non-business capital retained by the taxpayer is not such an expense." (R. br., p. 12-13)

Here, very clearly the suggestion is that the decision as to the application of a statute, general in terms, to a particular state of facts should be couched as in itself a general proposition of law. It is suggested that this proposition and the first proposition, if established, would result in "carving out" these expenditures as non-deductible, as lobbying expenses were excluded as not being "ordinary and necessary" under the decision relied on by the Respondent. (*Textile Mills Corporation* v. *Commissioner*, 314

U. S. 326 (1941)). Here, however, no issue is presented as to a class of expenditures always considered as falling outside the classification of "ordinary and necessary expenses." In many connections legal expenses are deductible under the tax statutes.

If decisions as to the status under the statute of legitimate expenses in a particular case are to be couched as "propositions of law," it seems obvious that almost any decision of the Tax Court can still be reviewed by the Circuit Courts of Appeal, and, in many cases, brought before this Court. Such a result would be the very negation of the principle laid down by this Court in the *Dobson* decision, and since consistently followed. *Commissioner* v. *Heininger*, 320 U. S. 467 (1943); *McDonald* v. *Commissioner*, 323 U. S. 57 (1944); *Commissioner* v. *Scottish American Investment Co., Ltd.*, 323 U. S. 119 (1944); *Commissioner* v. *Wemyss*, No. 629, October Term, 1944, decided March 5, 1945; *Commissioner* v. *Court Holding Company*, No. 581, October Term, 1944, decided March 12, 1945.

It is to be noted that the Court of Appeals for the Second Circuit, from which this case comes, in a later decision seems to observe the *Dobson* opinion as it did not here (*Chenago Textile Corporation* v. *Commissioner*, 2nd C. C. A., March 25, 1945). The fact that in the latter case the decision of the Tax Court had been against the taxpayer, while the decision of the Tax Court in this case was in favor of the taxpayer is immaterial.

II.

The respondent fails to meet the proposition of our Petition and Brief that the decision of the Tax Court, reversed by the Circuit Court of Appeals, was based on "no clear-cut mistake of law" (Main brief, p. 18).

Respondent maintains, as if it were an original question, that the expenditures here under consideration are not deductible under the statute. With this proposition the petitioners of course entirely disagree, as stated in their brief and as they did before the Tax Court. Yet the proposition of the Respondent is not responsive to the burden resting on the Respondent under the principle of the *Dobson* decision. That principle requires Respondent to show that the decision of the Tax Court was based on a clear-cut mistake of law.

Ample justification for the decision of the Tax Court is set forth in our main brief (p. 18). We there show that in this case the function of the Trustees (the Petitioners) was solely that of management. The petitioners had no interest whatever in the trust property, its consumption or disposition, and were solely fiduciaries managing property held for the production of income. There is no possible question of personal, family or living expenses, of personal transactions or obligations, or of income from personal services or any source other than the trust property. It was conceded in the Tax Court that the trust property was "held for the production of income" within the meaning of the statute (R. 33) and the Tax Court so found. It cannot now be contended that the trust property which produced $477,772.02 of net taxable income in the year 1940 (R. 8) was not "held for the production of income" but was held for distribution (R. br. 25). It was

held for both purposes from the beginning to the end. The Tax Court's determination of this fact, based on respondent's concession and substantial evidence, is final. There was no dispute over whether the claimed deductions were ordinary and necessary expenses (R. 33).

The sole question before the Tax Court was whether these particular expenses were for management of the trust property. The Tax Court held that they were, as the duty of the Trustees was to manage the property from the moment when they received it until they ultimately disposed of it, in accordance with the terms of the trust. Until such disposition was made there was no moment at which the Trustees ceased to hold and manage the property in their hands as income-producing property. The grounds for holding on these facts that under the statute the Tax Court was justified in concluding that the expenses are deductible were set forth in our main brief (Main br., p. 18).

Respondent maintains, however, that the history of the statute (Section 121, Revenue Act of 1942) shows that subsection 2 of section 23(a), added by that statute (Main br., pp. 2-3) was not intended to cover such expenditures as are here in question. Respondent relies wholly on what is said in the Committee Reports in regard to *executors and administrators of estates.* Nothing whatever is said in the Reports in regard to the application of the statute to trusts. As a matter of fact, the Reports show that the language was intended to be clear and comprehensive (Main br., p. 21).

Respondent appears to rely largely on an argument that the Regulations of the Commissioner negative the deduction. Respondent suggests that all deference to the determinations of the administrative bodies below the Circuit Courts of Appeal should be paid to the Commissioner

rather than to the Tax Court. It seems to the Respondent wholly objectionable that any question should be left to determination under the statute on the facts, without a governing pronouncement by the Commissioner. Respondent seems to ignore the idea so clearly expressed in the statutes that between the determination of the Commissioner and the ultimate liability of the taxpayer there should be a review by an independent body, in this case for most questions the Tax Court, as this Court has held.

It is to be noted that the decision of the Circuit Court of Appeals below was not based on any application of the Regulations of the Commissioner, but instead upon the Court's own view as to whether the disputed expenses could be regarded as incurred for the management of income producing property. That is where the difference between that Court and the Tax Court came in.

In fact, no Regulation of the Commissioner expressly deals with the question. Petitioners maintain that the governing regulation is that part of section 19.23(a)-15, reading as follows:

> "Reasonable amounts paid or incurred by a trustee on account of trustees' fees and other expenses which are ordinary and necessary in connection with the production or collection of trust income or with the management, conservation, or maintenance of trust property held for the production of income are deductible, notwithstanding that the trust is not engaged in a trade or business" (Main br., Appendix, p. 41).

Respondent relies on three expressions in the Regulations. These are the portion of section 19.23(a)-15 with respect to expenses of administration incurred by an administrator or executor (Main br., Appendix, p. 40); the portion of section 19.24-2 also dealing with expenses of

administration of an estate under the heading "capital expenditures" (Main br., Appendix, p. 43), and the portion of section 19.23(a)-15 dealing with expenditures incurred in tax controversies (Main br., Appendix, p. 42).

The Regulation with regard to expenditures of executors and administrators of estates is plainly not applicable to trustees, as we have stated in our main brief (p. 25). Respondent suggests that the treatment of trustees should be made the same. We believe, as the Tax Court held (R. 34), that there is ample ground for difference, and that in any case, if such result were intended, it should be and would have been expressed in the Regulations rather than left to be developed by construction.

As to capital expenditures, we have pointed out that in no view could these expenditures be regarded as within that category, as the Trustees were neither acquiring property nor defending the title to property in making these expenditures (Main br., p. 26).

The Regulation as to the non-deductibility of expenses incurred for the purpose of resisting a proposed additional assessment of taxes (other than taxes on property held for the production of income), if read alone, might seem to raise a question, as is pointed out in our main brief, page 27. But this portion of Section 19.23(a)-15 must be read in the light of the entire Regulation. If a particular expense is shown to be incurred for the management of income-producing property it is clearly deductible under the general provisions of the Regulation, even though incurred in connection with an income tax controversy. *Charles H. Manning*, 3 T. C. 853 (No. 108) (1944). Properly construed, the Regulation as to the deduction of expenses of tax controversies means only that such expenses are not deductible *as such*. The relationships of such expenses

to the production of income or the management of income producing property must be shown. If the Regulation means that expenses of tax controversies are not deductible, even though found to be expenses incurred for the management of property held for the production of income, the Regulation is not a construction of the statute, but an attempt to amend it. Clearly, it lay within the jurisdiction of the Tax Court to disregard such an attempt. It is, of course, to be borne in mind that the Regulation as to expenses of tax controversies has no bearing on the expenses here involved other than the expense of the income tax litigation.

It is striking that Respondent makes no contention as to the meaning of the word "management" used in the statute according to its common usage. He makes no claim that the activities of the Trustees here in question were not an ordinary, necessary and proper part of their duties in managing the trust property. His contentions seem to be directed not to the meaning of the statute but to the facts. He contends that the trust property was not "held" as a source of income (R. br. 20, 25), but that it was held for distribution, a question of fact decided against the Commissioner on his concession by the Tax Court; that the expenses should be treated as if they were expenses of administration of an estate (R. br. 21), which they clearly were not in fact; that the expenses bore no relation to the property as a source of income but had to do solely with its devolution (R. br. 22), a question of fact; that the expenses were capital expenditures (R. br. 23), a question of fact; that there was no proximate relationship between the litigation expenses and the property held for the production of income (R. br. 26), a question of fact; and that the Regulation as to expenses of tax controversies

bars the deduction of the tax litigation expenses because of a lack of the requisite proximate relation to the property (R. br. 27) although the Tax Court found as a fact that the necessary relationship of the expenses to the management of the trust property existed.

Respondent seems to place some reliance on decisions of the lower Courts in other cases. These, as we maintain in our main brief (p. 28), turned on the particular facts or failure of proof. We have no quarrel with Respondent's proposition:

> "Deduction of the expenses of contesting taxes, which have not been shown to have a proximate relation to the management, or preservation of property held for the production of income, or to income from the property, has not been allowed". (R. br., p. 28).

We accept that result, but point out that the fact here is that the Tax Court determined that the tax litigation expenses, like the other expenses in controversy, had "a proximate relation to the management or preservation of property held for the production of income." Respondent attempts in his brief to argue that that conclusion was incorrect as did the Court below. Our position remains that on the decision of that question of fact—on which the result in the case turns—the decision of the Tax Court was final.

Respectfully submitted,

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